

Office of Chief Counsel  
Internal Revenue Service

memorandum

CC:LM:RFPH: [REDACTED]; POSTF-138907-02  
[REDACTED]

date: October 30, 2002

to: [REDACTED]  
Manager, LMSB Group [REDACTED]  
[REDACTED]

from: Associate Area Counsel - [REDACTED]  
(Retailers, Food and Pharmaceuticals)

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subject: Deductibility under I.R.C. §162(a)(3) and §467 of Amounts to be  
Paid under Facilities Agreement related to [REDACTED] at  
the [REDACTED]

**Taxpayers:**

- (1) [REDACTED]  
E.I.N.: [REDACTED]
- (2) [REDACTED]  
E.I.N.: [REDACTED]
- (3) [REDACTED]  
E.I.N.: [REDACTED]
- (4) [REDACTED]  
E.I.N.: [REDACTED]

This memorandum responds to your request for assistance dated July 16, 2002 related to whether payments made and to be made by [REDACTED] to [REDACTED]

[REDACTED] under the Facilities Agreement between [REDACTED] and the [REDACTED] executed in [REDACTED] constitute deductible rent under I.R.C. §162(a)(3) and §467 or nondeductible capital expenditures under I.R.C. §263.

Based on the following discussion, we have concluded the following:

- a. [REDACTED] is not the owner of an [REDACTED] located at the [REDACTED]. It lacks sufficient burdens and benefits of an owner under applicable state and federal law.

b. Payment obligations of [REDACTED] under the Facilities Agreement do not constitute deductible rent expense under I.R.C. §162(a)(3) and §467. These amounts were not paid for the use of the property, but are nondeductible capital expenditures under I.R.C. §263 that cannot be amortized or deducted under an election under I.R.C. §142(b)(1).

(b)(5)(AC), (b)(7)a [REDACTED]

### Issues

1. Whether [REDACTED] is the owner of improvements known the [REDACTED] at the [REDACTED].  
U.I.L.: 167.15-00; 167.15-02; 167.15-03

2. If [REDACTED] is not the owner of the [REDACTED] whether payment obligations under the Facilities Agreement constitute rent deductible under I.R.C. §162(a)(3) and §467.  
U.I.L.: 162.09-03; 162.09-09; 162.09-17; 162.26-00; 162.30-00; 263.08-01; 263.08-04; 263.15-00

3. If the payments under the Facilities Agreement are not deductible rent, whether they are nondeductible capital expenditures under I.R.C. §263. U.I.L.: 263.08-01; 263.08-04; 263.15-00

4. If the payment obligations are nondeductible capital expenditures under I.R.C. §263, whether the election not to claim depreciation under I.R.C. §142(b)(1) related to the [REDACTED] prohibits deductions of such payment obligations.  
U.I.L.: 142.01-01

### Facts

Through at least [REDACTED] [REDACTED] was the parent of a group of subsidiaries (the [REDACTED]) that are engaged in the business of [REDACTED]. Four of these subsidiaries are [REDACTED], [REDACTED], and [REDACTED].

During [REDACTED], [REDACTED] replaced

[REDACTED] as the parent of the [REDACTED].

The [REDACTED], which uses the accrual method, filed consolidated federal corporate income tax returns (Form 1120) on a calendar year basis through at least the taxable year ended December 31, [REDACTED].

[REDACTED]

[REDACTED]

[REDACTED]

#### Facilities Agreement

One of these agreements was the Facilities Agreement dated [REDACTED] (FA) between [REDACTED] and [REDACTED]. The purpose of the FA was to induce the purchase of and secure payment of the bonds. See [REDACTED] of the FA.

The last paragraph of the introductory portion of the FA contained the following language:

NOW, THEREFORE, for and in consideration of the premises and the mutual covenants hereinafter contained, the parties hereto hereby formally covenant, agree and bind themselves as follows, ...

See [REDACTED] of FA.

The FA specifically limited its use of the words "[REDACTED]" and "[REDACTED]" to the terms of the FA. See [REDACTED] of FA.

Under the FA, the [REDACTED] agreed to issue bonds to finance the construction costs of the [REDACTED] in exchange for [REDACTED]'s unconditional agreement to pay to [REDACTED], the trustee under the related bond indenture, amounts necessary to satisfy all of [REDACTED]'s obligation to timely pay principal, premiums, and interest under the bonds. See [REDACTED] of the FA; [REDACTED] of trust indenture discussed below. The term of the FA commenced upon the date of issuance and delivery of the bonds until their satisfaction. See [REDACTED] of the FA.

[REDACTED]'s payments under the FA were the sole source for payments on the bonds and could not be used by [REDACTED] for any other purpose. See [REDACTED] of the FA. [REDACTED] assigned its interest in the FA and related payments to [REDACTED] as security for the payments due on the bonds. See [REDACTED] of the FA.

[REDACTED] was responsible for the design and construction of the facility. See [REDACTED] of the FA. To the extent that the bond proceeds were insufficient to pay for the construction costs, [REDACTED] would pay the costs from other sources without entitlement to reimbursement for such excess costs from [REDACTED] or the bondholders. See [REDACTED] of the FA.

To the extent that [REDACTED] used its own funds to pay costs of construction in excess of the bond proceeds, these excess costs would be treated as "payment of additional amounts for the use" of the facility. See [REDACTED] of the FA.

With the exception of the treatment of construction costs as "[REDACTED]" of the facility, the remaining

provisions of the FA demonstrated that the ground lease and [REDACTED] dated [REDACTED], as amended ([REDACTED]), are the only agreements that govern the [REDACTED]'s right to use the property and rental obligations. See [REDACTED] of the FA. First, the FA stated that [REDACTED]'s right of possession, use, and occupancy of the facility was governed by the ground lease and [REDACTED]. See [REDACTED] of FA.

Second, the rights, obligations, and remedies of the parties under the FA were not dependent on compliance with defaults under the ground lease and [REDACTED]. See [REDACTED] of the FA. For example, the FA stated that [REDACTED]'s obligation for the FA payments was not affected by any default, eviction, dispossession, termination, damage or destruction of the facility, liability, amendment to, or any other event or circumstance related to the ground lease and [REDACTED]. See [REDACTED] of the FA. Furthermore, the provisions of or termination of the FA did not and was not intended to limit or effect any of the rights, obligations, and remedies of the [REDACTED] and [REDACTED] under the ground lease and [REDACTED]. See [REDACTED] of the FA.

Third, [REDACTED] of the FA, which authorized actions by [REDACTED] to collect FA payments and enforce FA covenants, withheld from [REDACTED] the rights of repossession normally associated with defaults under leases of property through the following language:

[REDACTED]

See [REDACTED] of the FA.

None of the FA payments or related investment income could be applied to [REDACTED]'s rent obligations or reduced by any

obligations or liabilities under the ground lease or . See of the FA.

In the "Tax Covenants" of the FA, made an election under I.R.C. §142(b) not to claim depreciation with respect to the . See of the FA. In addition, the FA treated the as the owner and as the mere lessee of the . See .

#### Ground Lease Related to

By ground lease executed by (ground lease), the leased to of land at the with the rights to construct and use the to be constructed thereon for a period that commenced on and ended on . See of the ground lease. Unless modified by a written agreement between the and s use of the property was limited to use as an . See of the ground lease.

With the approval by the , the ground lease would automatically renew for years ending on . See of ground lease.

The introductory portion of the ground lease contained the following language:

....

See of ground lease.

[REDACTED]'s use of the property was subject only to the terms of the ground lease, federal and state laws, codes, regulations, and municipal ordinances governing [REDACTED]. See Sections [REDACTED] of ground lease. The ground lease did not refer to or incorporate any provisions, obligations, or payments under the FA or related guaranty, bonds, or indenture discussed below.

The rent to be paid by [REDACTED] for the use of the property consisted only of the rentals, fees and charges provided in the ground lease. See pages [REDACTED] of ground lease. [REDACTED]'s obligation to pay rent commenced on the date of [REDACTED]'s "[REDACTED]" of the property: the earlier of the [REDACTED]'s issuance of a certificate of occupancy (CO) upon completion of construction of the facilities or [REDACTED]. See Sections [REDACTED] of the ground lease.

For the initial [REDACTED]-year term, the ground lease required [REDACTED] to pay annual base rent (ABR). ABR commenced on the first day of each month after commencement of [REDACTED]'s rental commencement date and was payable in monthly installments. ABR was computed based on the per-acre rate charged other [REDACTED] tenants under the formula set forth in any [REDACTED] in effect throughout the lease period. Subject to changes set forth in the [REDACTED], the components of the formula for computing the annual per-acre rental consisted of two estimates for the next succeeding fiscal year: (a) an estimate of the [REDACTED]'s costs of operating the [REDACTED]; and (b) the total developed acreage of the [REDACTED]. As of [REDACTED], the per-acre rate charged [REDACTED] was \$[REDACTED]. See Sections [REDACTED] of the ground lease.

Although we do not know the date that the [REDACTED] issued the CO or [REDACTED] commenced payment of ABR, the [REDACTED]'s claim that it was entitled to depreciation commencing in [REDACTED] reflects issuance of the CO by [REDACTED]. Consequently, we assume that [REDACTED] commenced payment of ABR during [REDACTED].

[REDACTED] was entitled to rent abatements or credits only in the circumstances set forth in the ground lease. None of the circumstances resulting in rent abatements and credits would occur under any provisions, rights, obligations, defaults, or remedies set forth in the FA or agreements related to financing the construction of the facility through bonds or payments to satisfy the bonds. See Sections [REDACTED]

[REDACTED] of the ground lease.

Subject to written approval of the [REDACTED], [REDACTED] was responsible for all aspects of construction of the facility. See Sections [REDACTED] of the ground lease. However, the [REDACTED], at its sole expense and cost, agreed to construct, maintain, repair, and make available to [REDACTED] utilities, drainage facilities, fuel lines, access streets, and traffic aids and devices up to the boundary line of the premises and an [REDACTED]. See Sections [REDACTED] and [REDACTED] of the ground lease.

In addition to the amounts specifically labeled rent in the ground lease, [REDACTED] agreed to pay the following:

- a. [REDACTED]% of the costs of construction of an [REDACTED]. However, [REDACTED] would be reimbursed these costs through a credit against [REDACTED]'s ABR obligation. This credit would be amortized monthly from the date of commencement of [REDACTED]'s beneficial occupancy until satisfied. See Section [REDACTED] of the ground lease.
- b. [REDACTED]'s share of the costs of constructing, relocating, and extending utilities or improvements that benefit and are subsequently requested by [REDACTED]. See Section [REDACTED] of the ground lease.
- c. All taxes and other governmental charges assessed against the leasehold interest and [REDACTED]. See Section [REDACTED] of the ground lease.
- d. The costs of reasonable repair, maintenance, and replacement of the [REDACTED]. See Section [REDACTED] of the ground lease.
- e. The costs of maintaining and repairing service lines in and out of the premises. See Section [REDACTED] of the ground lease.
- f. The costs of installing, maintaining, and operating obstruction lights on the premises. See Section [REDACTED] of the ground lease.



g. The cost of casualty insurance for at least % of insurable value of the and fixtures and equipment on the property. was required to name the the and as loss payees in accordance with their respective interests. When the cost of repair and replacement was at least % of the original cost of the improvements, any insurance proceeds payable upon damage or destruction by a casualty had to be first used to repair or replace the improvements to the condition before the loss. Any excess proceeds after payment of the cost of repairs or replacement was then payable to the and in accordance with their respective interests. However, if the cost of such repairs was less than % of the original cost, had an election to repair and replace the premises with the insurance proceeds or terminate the lease and use the proceeds to restore the property back in its pre-construction condition. If insurance proceeds were insufficient to repair or replace the improvements or to restore the property to its pre-construction condition under the preceding scenarios, had to pay the deficiency. See Section of the ground lease.

h. The costs of insurance incurred during the period of construction of the for workers compensation and employers' liability, comprehensive general liability, comprehensive vehicle liability, liability, builders' risk, and umbrella liability. See Section of the ground lease.

i. The costs of insurance incurred during the period of s occupancy for workers compensation and employers' liability, comprehensive general liability, comprehensive vehicle liability, liability, all risk coverage for % of the replacement cost of the and umbrella liability. See Section of the ground lease.

Events of default under the ground lease that would result in early termination of the lease and allow the 's exercise of its right to reenter the premises were limited to the 's failure to comply with its ground lease covenants and failure to cure or commence and diligently pursue curative action related to such default within days of receipt of a written notice of default. See Sections of the ground lease.

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The [REDACTED] became the owner of the [REDACTED] upon completion of the facility. See Sections [REDACTED] of the ground lease. In addition, the ground lease specifically excluded any rights in the [REDACTED] over the property more than [REDACTED]. See Section [REDACTED] of ground lease.

In addition, the lease reserved to the [REDACTED] numbers of burdens and benefits associated with property ownership. First, [REDACTED] could not assign or sublet any portion of the [REDACTED] without prior written consent of the [REDACTED]. See Section [REDACTED] of the ground lease.

Second, during the lease term, the [REDACTED] retained its right to enter upon and inspect the property and perform any necessary inspections of, repairs to, and maintenance of the property and utilities and other systems at the [REDACTED]. See Sections [REDACTED] of the ground lease.

Third, [REDACTED] had a relatively minor interest in the proceeds of proceeds of eminent domain, condemnation, or other proceedings. For example, if the entire property is taken through such proceedings, the proceeds of such proceedings would be distributed as follows:

- a. First, to pay the amount necessary to satisfy any real property tax liens, assessments, and other governmental charges against the property.
  - b. Second, to satisfy or reduce any then outstanding bonds by an amount equal to the then fair market value of the [REDACTED]
  - c. Third, to compensate [REDACTED] by an amount necessary for the fair market value of [REDACTED]'s conveyor system, fixtures, and personal property then attached to the property.
  - d. Fourth, to pay the [REDACTED] an amount equal to the present value of the ABR related to the land that would have been payable for the unexpired portion of the lease term.
  - e. Fifth, to pay the [REDACTED] an amount equal to the residual value of the improvements comprising the [REDACTED].
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f. Sixth, the balance would be paid to [REDACTED]

See [REDACTED] of ground lease.

In addition, if only a portion of the property is taken through eminent domain, condemnation, or other proceedings, the proceeds of such proceedings would be paid to the [REDACTED] and distributed as follows:

a. First, to pay for any necessary expenses to restore, repair, or refurbish the remainder of the [REDACTED].

b. Second, the manner provided for in a total taking.

See [REDACTED] of ground lease.

Furthermore, if there is only a temporary taking of the property through eminent domain, condemnation, or other proceedings, [REDACTED] was entitled to receive all proceeds unless the period of temporary taking exceeds the unexpired term of the lease. If the period of temporary taking equals or is less than the unexpired term of the lease, the proceeds would be distributed as follows:

a. First, to pay the [REDACTED] for any estimated expenses to restore, repair, or refurbish the [REDACTED] as the result of any damage during such temporary taking.

b. Second, the balance apportioned between the [REDACTED] and [REDACTED].

See [REDACTED] of ground lease.

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Fourth, the [REDACTED] specifically reserved all mineral rights related to the property by the following language:

[REDACTED]

See [REDACTED] of ground lease.

Fifth, with minimal exceptions, [REDACTED] could not erect or affix any structures, improvements, or fixtures (other than trade fixtures) to the property or modify or make any material additions, improvements, or replacements on the property at any time. See Sections [REDACTED] of ground lease. Unless [REDACTED] or the [REDACTED] took specified actions, the [REDACTED] also owned [REDACTED] upon installation on the premises. See Section [REDACTED] of the ground lease.

[REDACTED]'s interest in any property attached to the premises was limited to personal property acquired with funds other than bond proceeds. This property consisted of trade fixtures (such as display signs, counters, and [REDACTED] furniture, equipment (such as [REDACTED], [REDACTED], and other items of personal property installed on the premises (to the extent they could be removed without material damages to the facility) were owned by [REDACTED]. See Sections [REDACTED] of the ground lease.

If the [REDACTED] needed the property at any time during the lease term, the [REDACTED] could relocate [REDACTED]'s fixtures

and personal property to another location at the [REDACTED] that would include an [REDACTED] containing equivalent improvements. The [REDACTED] would bear the costs of such relocation. With the exception of an adjustment to the ABR based on the acreage of the new location, the terms of the ground lease did not change. If the [REDACTED] could not relocate [REDACTED] to a satisfactory location, the [REDACTED] could terminate the lease. See Section [REDACTED] of ground lease.

During only the two-year extension of the lease term after [REDACTED], in addition to the annual rent, [REDACTED] would commence paying additional annual rent equal to the fair rental market value of the portion of the [REDACTED] financed with the bonds to the extent necessary to preserve the exclusion under I.R.C. §103 for the interest income on the bonds. This fair rental value would be determined at the time such additional annual rent is due. See Sections 2.B.3. and 25 of the ground [REDACTED].

[REDACTED] agreed that it would not permit a lien or any other encumbrance to attach to its leasehold and the [REDACTED]. See Sections [REDACTED] of the ground lease.

The ground lease contained an integration clause reflecting that the ground lease was the entire agreement on the subject matter of the lease and could not be changed, except by [REDACTED] resolution and by written agreement of the parties. See Section [REDACTED] of the ground lease.

The ground lease gave [REDACTED] an option to add additional acreage at the [REDACTED] to its leasehold interest for [REDACTED] years after commencement of [REDACTED]'s beneficial occupancy of the property (expansion option). The cost of this option was the sum of [REDACTED]% of the per-acre ground rent on the expansion area payable in equal monthly installments that would commence on the first day of the first month of such [REDACTED]-year period. Upon written notice within the period of the option, [REDACTED] could extend the term of the expansion option for an additional [REDACTED]-year period in exchange for an annual fee equal to [REDACTED]% of the per-acre ground rental rate on the expansion area payable in monthly installments. See Section [REDACTED] of ground lease. However, [REDACTED] did not possess any option or right to acquire any interest in the property greater than a leasehold interest.

Exhibit B (Certificate of Weighted Economic Life) to the ground lease reflects that the [REDACTED] would have a

[REDACTED]  
weighted average economic life of [REDACTED] years with a value of  
\$ [REDACTED] at the anticipated time of [REDACTED]'s possession.

[REDACTED] Related to Improvements  
Other Than [REDACTED] Leased to [REDACTED]

The [REDACTED]'s use of the [REDACTED] premises other than the  
[REDACTED] leased to [REDACTED] was subject to the [REDACTED]  
[REDACTED]. See Section [REDACTED] of the ground lease. By [REDACTED]  
[REDACTED], the [REDACTED] had been amended [REDACTED] times.  
However, the file does not indicate the dates of the [REDACTED]  
amendments or signature on behalf of any member of the [REDACTED].

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

In addition, the agreement stated:

[REDACTED]

See [REDACTED] of the [REDACTED].

The [REDACTED] contained an integration clause stating that it was the entire Agreement on the subject matter the [REDACTED] and could not be changed except by written instrument executed by the [REDACTED] and [REDACTED]. See Section [REDACTED] of the [REDACTED].

#### Trust Indenture

Under the Trust Indenture as of [REDACTED] (indenture) between the [REDACTED] and [REDACTED], [REDACTED] transferred its interest in the FA and related payments to [REDACTED], as trustee, for the benefit of the bondholders. See pages [REDACTED] of indenture. The trust would terminate only upon satisfaction of all payments required under the bonds and indenture and [REDACTED]'s trustee fees and expenses. See Article [REDACTED] of the indenture.

The indenture required the creation of three accounts to be maintained by [REDACTED] in its trustee capacity: (a) the "Construction Fund" (C-Fund); (b) the "Debt Service Fund" (Debt Fund; and (c) the "Special Rebate Fund" (Rebate Fund). See Articles [REDACTED] of the indenture. The Debt and Rebate Funds were to be maintained until the bonds were satisfied.

The substantial majority of the bond proceeds were to be deposited into the C-Fund for payment of the costs of constructing the [REDACTED]. Upon receipt of "Disbursement Requests" prepared by [REDACTED] that reflected costs that did not exceed the bond proceeds, [REDACTED] disbursed funds to pay such costs directly to [REDACTED] or other persons entitled to payment. See Section [REDACTED] and Article [REDACTED] of the indenture; Section [REDACTED] of the FA. If funds in the C-Fund



exceeded the cost of construction of the facility, ██████ had authority to apply such excess funds to the payment of bonds. See Article ██████ of the indenture.

Deposits into the Debt Fund consisted of \$█████ of the bond proceeds and ██████'s FA payments. See Section ██████ and Articles ██████ of the indenture. In addition, upon receipt of a "Disbursement Request", ██████ could transfer funds from the C-Fund to the Debt Fund to pay interest due on the bonds. See Articles ██████ of the indenture.

The Rebate Fund was for the benefit of ██████ and the United States. Deposits into the Rebate Fund consisted of the payments required by ██████ under I.R.C. §148 and the FA. See Article ██████ of the indenture. However, the file does not reflect whether any such payments were ever required or made.

As with the FA, a number of provisions of the indenture and bonds indicated that the rights, obligations, and remedies under the FA had no relationship to those set forth in the ground lease and the ██████ for ██████ and the ██████. First, the indenture and related bonds incorporated covenants of the FA and related guaranty, but did not incorporate any covenants of the ground lease and ██████. See Sections ██████ and Articles ██████ through ██████, inclusive, ██████ of the indenture; pages ██████ of each bond. The only relevant defaults were under the provisions of the FA, guarantee, and indenture. See Section ██████ and Article ██████ of the indenture. In addition, nothing in the indenture, bonds, FA, and guaranty relieved ██████ of its obligations to pay rent under the ground lease and ██████.

Second, ██████ was authorized to enforce bondholders' rights and remedies upon defaults under the FA, indenture, guaranty, but not the rights and obligations of ██████ and the ██████ under the ground lease and ██████. See Articles ██████ of the indenture.

Third, the bonds were the sole obligation of ██████ and payable only from ██████'s payments under the FA. Thus, no other governmental unit located in ██████ including the ██████ had any obligation to pay any amounts under the bonds. See Article ██████ of the indenture.

Fourth, while the bonds also were secured by first lien on the FA payments to be made by [REDACTED], the [REDACTED] leased to [REDACTED] and the rent under the ground lease and [REDACTED] were not subject to any interest or security interest for the bondholders' benefit. See Article [REDACTED] of indenture. More specifically, the bonds expressly forbid collection by [REDACTED] or bondholders of any bond payments from the [REDACTED] or the [REDACTED] leased to [REDACTED] or related revenues under the ground lease and [REDACTED]. See Article [REDACTED] of the indenture; pages [REDACTED] and [REDACTED] of each bond.

Fifth, like the FA, the indenture withheld from [REDACTED] and the bondholders the remedies normally available to a landlord on default under a lease upon default in payments under the FA, indenture, and guaranty. See Article [REDACTED] of the indenture.

Sixth, no amounts paid to, collected by, deposited with, or investment income from trust assets received by [REDACTED] under the indenture could be applied to satisfy any portion of [REDACTED]'s rent obligations under either the ground lease or the [REDACTED]. See Articles [REDACTED] of the indenture.

### Bonds

Pursuant to the indenture, the [REDACTED] issued and sold bonds in the aggregate amount of \$[REDACTED]. These bonds were dated [REDACTED], bore interest from [REDACTED] until maturity or redemption at an annual rate of [REDACTED]%, and would mature on [REDACTED]. Commencing [REDACTED], the interest was payable on each [REDACTED] and [REDACTED] until the bonds were satisfied. See Sections [REDACTED] and Articles [REDACTED] of the indenture.

As of [REDACTED], the bonds were redeemable before maturity. See Article [REDACTED] of the indenture. However, there have been no redemptions.

### Guaranty

To enhance the marketability of the bonds and achieve savings of interest and other costs, [REDACTED] executed a guaranty dated [REDACTED] in favor of [REDACTED] as trustee under the indenture. See page [REDACTED] of guaranty. Under this guaranty, [REDACTED] unconditionally guaranteed all timely

payments of principal, bond premium, and interest to be made to the bondholders until the bonds were satisfied. See Sections [REDACTED] of the guaranty.

The guaranty did not guarantee any payments by [REDACTED] under the ground lease or [REDACTED]. All payments made by [REDACTED] and rights of enforcement granted under the guaranty were for the benefit of bondholders and all payments would be applied in accordance with the bond indenture. See Sections [REDACTED] of the guaranty. In addition, the obligations of [REDACTED] and rights of bondholders against [REDACTED] were not impacted by any actions, omissions, or defaults related to the ground lease or [REDACTED]. See Sections [REDACTED] of the guaranty. Furthermore, default under the guaranty occurred only with respect to untimely payments on the bonds. See Sections [REDACTED] of the guaranty.

The guaranty reflected that the [REDACTED] was to be leased to or used by [REDACTED] pursuant to agreements other than the FA. See page [REDACTED] of the guaranty.

#### Bond Purchase Agreement

[REDACTED] were the underwriters of the bonds.

Pursuant to the bond purchase agreement dated [REDACTED] among [REDACTED], [REDACTED], [REDACTED], and [REDACTED], [REDACTED] purchased all of the bonds issued by [REDACTED] at a price that consisted of [REDACTED]% of the aggregate principal amount totaling \$[REDACTED] and accrued interest from [REDACTED] to date of payment for and delivery of the bonds (Closing Date).

The bond purchase agreement echoed the provisions in FA, indenture, and guaranty that all payments on the bonds would be made from the FA payments made by [REDACTED] to [REDACTED]. In addition, there is no language in the bond purchase agreement related to any rights, payments, and obligations under the ground lease or [REDACTED].

#### Construction Costs Paid with Bonds and Asset Recovery Periods

We understand that the bond proceeds funded all costs of

construction for the . The following reflects these construction costs, the dates the improvements were placed in service, and recovery periods assigned by the to the facilities under the modified cost recovery system (MACRS) and alternative (alt.) MACRS:

<u>Property</u>	<u>Cost of Construction</u>	<u>Month Placed in Service</u>	<u>Recovery Period</u> <u>MACRS</u>	<u>Alt. MACRS</u>
Building	\$			
Leasehold				
Improvements				
(L-I'ments)				
L-I'ments				
L-I'ments				
L-I'ments				
L-I'ments				
L-I'ments				
L-I'ments				
L-I'ments				
L-I'ments				
L-I'ments				
L-I'ments				
L-I'ments				
L-I'ments				
Total	\$			

(b)(5)(A)(C)

's Actual Payments under the Ground Lease, , and FA and Financial and Tax Treatment

The file does not indicate the specific amounts of items of rent and other items that paid under the ground lease and or the exactly how the classified such amounts in their financial and tax records. There is no evidence to reflect that was liable for or paid any late charges related to rents under the lease and use agreements.

We understand that timely paid approximately \$ per year to under the FA and that these

payments were sufficient to service the interest obligations on the bonds.

Until [REDACTED] the [REDACTED] had treated its FA obligations as long-term debt. When [REDACTED] issued the bonds, the [REDACTED] credited a long-term debt account with \$ [REDACTED] for the principal of the bonds. As of the date of this memorandum, the [REDACTED] continues to show that amount as a debt in its financial records. However, the amount of the debt changes monthly for amortization of the discount. This amortization is recorded as interest in books and deducted as interest on tax returns.

The [REDACTED] treated the FA payments sufficient to satisfy the interest on the bonds to [REDACTED] through at least [REDACTED] as interest expense and claimed deductions under I.R.C. §163 on its Forms 1120. Under I.R.C. §263(a), [REDACTED] capitalized part of the interest payments made during [REDACTED] and [REDACTED].

The [REDACTED] has treated the assets purchased with the bond proceeds as capital assets owned by the [REDACTED] for financial and tax purposes.

In addition, for financial and tax purposes, the [REDACTED] capitalized bond expenses of \$ [REDACTED] and amortized them over the life of the bonds at the rate of \$ [REDACTED]. We assume that these expenses include payments to [REDACTED] as underwriters of the bond issue.

Through at least the taxable year ended [REDACTED] the [REDACTED] has not claimed any deductions for any obligation to pay the principal due on the bonds during [REDACTED] under any Internal Revenue Code provision.

The [REDACTED] has claimed deductions for rent under I.R.C. §162(a)(3) for payments of the amounts defined as [REDACTED] in the ground lease on all of its Forms 1120 commencing with the year ended [REDACTED]. However, the file does not reflect the tax or financial treatment by the [REDACTED] of the other payment obligations under the ground lease, such as expenses of [REDACTED]

The Internal Revenue Service (Service) has not challenged the deductions claimed for the [REDACTED] and other payment obligations under the ground lease, any deductions for rent under the

[REDACTED] Agreement under I.R.C. §162(a)(3), amounts of FA payments sufficient to satisfy the amounts of interest due to the bondholders, or amortization deductions for expenses related to issuance of the bonds.

On its [REDACTED] and [REDACTED] Forms 1120, [REDACTED] claimed deductions for depreciation under I.R.C. §168 computed under regular MACRS in the respective amounts of \$ [REDACTED] and \$ [REDACTED] related to the [REDACTED]. The deductions for [REDACTED] related to the building completed in [REDACTED] and for [REDACTED] related to the building and leasehold improvements completed in [REDACTED].

We understand that the [REDACTED] also claimed deductions for depreciation in taxable years after the taxable year [REDACTED].

During the Service's examination of the [REDACTED]'s Forms 1120 for [REDACTED] through [REDACTED], [REDACTED] conceded that it improperly claimed depreciation deductions related to the [REDACTED] for [REDACTED] and [REDACTED]. However, [REDACTED] has not executed any closing agreement reflecting its agreement to the disallowed depreciation deductions.

In addition, the [REDACTED] has conceded that it is not entitled to deductions under I.R.C. §167 and §168 in subsequent years. However, the file does not indicate that the [REDACTED] has not claimed deductions for the costs of the [REDACTED] or payment obligations under the FA under provisions other than I.R.C. §167 and §168 (such as I.R.C. §162(a)(3) and §467) for the subsequent taxable years.

#### [REDACTED] Position

Despite the agreed disallowance of deductions for depreciation claimed by the [REDACTED], the [REDACTED] now asserts in the Service's examination of Forms 1120 for [REDACTED] through [REDACTED] that it is entitled to deductions under the rent-leveling provisions of I.R.C. §467 for the payments under the FA. Such claimed deductions consist of [REDACTED]'s payment obligations for (a) interest due on the bonds during a year and (b) a pro rata allocation of the one-time payment of principal of approximately \$ [REDACTED] due in [REDACTED] from [REDACTED] through [REDACTED].

[REDACTED] argues that the rent-leveling provisions of I.R.C. §467 apply based on six factors. First, because [REDACTED] can never own and claim depreciation under I.R.C. §142 with respect to the [REDACTED] and the bonds retain their tax-exempt status,

[REDACTED] had to lease the property to use the property and pay rent for such use. Second, [REDACTED] concedes that it is not entitled to any deductions under I.R.C. §167. Third, [REDACTED]'s FA payment obligations are essentially equal to the [REDACTED]'s interest and principal obligations under the bonds. Fourth, the terms of the FA, [REDACTED]

[REDACTED]'s Forms 1120 for [REDACTED] through [REDACTED] identify [REDACTED]'s FA obligations as payments constituting rent under the Internal Revenue Code. Fifth, the FA payments constitute uneven rent requiring rent leveling under I.R.C. §467. Sixth, because [REDACTED] has never owned and can never own the property, this case does not involve a disqualified sale-leaseback under I.R.C. §467.

However, the [REDACTED]'s argument is not supported by the specific provisions of the ground lease or any other documents and circumstances that demonstrate that any of the FA payment obligations constitute rent for [REDACTED]'s use of the property.

Although the [REDACTED] raised the issue under I.R.C. §467 in a memorandum dated [REDACTED] to members of the LMSB team responsible for the examination of the [REDACTED] through [REDACTED] Forms 1120, we do not know whether the [REDACTED] has raised the issue with the Appeals Office handling the protest of adjustments to Forms 1120 for [REDACTED] through [REDACTED]

#### [REDACTED] Other Similar Leasing Transactions

In [REDACTED] the [REDACTED] engaged in at least one other transaction that involved the use of bonds to finance the acquisition and construction of leased facilities. While the transaction did not involve tax-exempt facility bonds under I.R.C. §142, it involved long-term lease agreements related to a [REDACTED] leased to [REDACTED] subsidiaries by the [REDACTED] and a guaranty related to the bond payments by [REDACTED]. Unlike the rental payments for the use of the [REDACTED] at the [REDACTED], the payments for the use of the distribution facility leased to the [REDACTED] subsidiaries had the following significant characteristics:

- a. They were paid to the bond trustee on behalf of the issuer of bonds, which was also lessor-owner of the property.

- b. They were the sole source of payment for the bonds.
- c. The lease agreements provided for rent for the use of the property to be paid in amounts sufficient to pay the amounts of principal of and interest on the dates set forth in the indenture and bonds.
- d. Amounts held by trustee for payment of bonds were to be credited to the next succeeding rental payment under the lease agreements. If these amounts were sufficient to pay principal and interest, the [REDACTED] subsidiaries were relieved of their obligation to make any further rent payments.
- e. All rights in and rents under the lease agreements were pledged as security for payment of the principal and interest of the bonds.
- f. A default under the lease was a default under the bond indenture.
- g. Upon default, bondholders had the right to re-enter and take possession of the property.

In addition, [REDACTED] had the right to purchase the project for \$ [REDACTED] upon termination or expiration of the lease. Furthermore, the related trust indenture required the trustee to deliver a warranty deed and bill of sale to [REDACTED] upon satisfaction of the bonds.

Under the lease, [REDACTED] could and did sublease the facility to [REDACTED]. [REDACTED] also assumed obligations to pay all costs of maintenance, modifications, taxes, and insurance.

The [REDACTED] treats [REDACTED] as the owner of the leased premises with entitlement to all deductions associated with an owner (the person possessing sufficient burdens and benefits of ownership). These deductions include rent under I.R.C. §162(a)(3) (netted against rental income from the sublease and interest income from the bonds) and depreciation under I.R.C. §167.

#### Miscellaneous Facts

There is no evidence to indicate that the [REDACTED] and [REDACTED] are not legally independent entities and that the [REDACTED]



[REDACTED] ever granted any right to [REDACTED] to act on its behalf with respect to the property.

[REDACTED] law governed the construction and validity of each agreement. See Section [REDACTED] of ground lease; Section [REDACTED] of [REDACTED]; Sections [REDACTED] of FA; Section [REDACTED] of bond purchase agreement; Article [REDACTED] of the indenture; and Section [REDACTED] of the guaranty.

The file does not indicate that any of the agreements are defective for failure to comply with any formal requirements under the [REDACTED] Statutes of Fraud or recording statutes.

The file does not reflect the existence of any other amendments to the FA, the ground lease, indenture, bond purchase agreement, bonds, or guaranty executed by [REDACTED] [REDACTED] the [REDACTED], the [REDACTED] and [REDACTED].

In addition, the file does not reflect any circumstances that allowed or documents evidencing that [REDACTED] was entitled to any rent abatements or credits, that [REDACTED] incurred any late payment charges under the ground lease, that [REDACTED] took any action with respect to the expansion option, or that any events constituting defaults have occurred under the ground lease.

There is no evidence of any tax-avoidance motive on behalf of the [REDACTED] or lack of good faith.

The only references to provisions of the Internal Revenue Code in the relevant agreements were to I.R.C. §103, §142, §147, §148, and §149.

With the exception of the [REDACTED]'s attempt to claim deductions for depreciation and amortization related to the facilities paid for with bonds under I.R.C. §142, the file does not reflect that the [REDACTED] has violated any other requirements under I.R.C. §103, §147, §148, or §149 and applicable federal or state regulations for tax-exempt bonds. We are not aware of any challenge by Service to the tax-exempt status of the bonds.

#### Issue 1 - Legal Discussion

The nature of a taxpayer's property interest is determined by applicable state law. Aquilino v. United States, 363 U.S. 509, 512-13 (1960); Morgan v. Commissioner, 309 U.S. 626 (1940).

Aguilino, 363 U.S. at 512-14; Morgan, 309 U.S. 626.

Applicable State Law

Because the real property is located in [REDACTED] and all agreements provide for the application of [REDACTED] law, the determination of the nature of the interest granted to [REDACTED] is governed by [REDACTED] Law.

[REDACTED], (b)(5)(AC), (b)(7)a

[illegible]

(b)(5)(AC), (b)(7)a

[REDACTED]

(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a

### Applicable Federal Law

Like [REDACTED] courts, the federal courts generally respect the covenants between a lessor and lessee respecting the ownership of improvements during the term of a lease. Commissioner v. Hills Corp., 115 F.2d 322, 323 (10th Cir. 1940); [REDACTED] (lease expressly provided that ownership of improvements on [REDACTED] real property vested in county-lessor upon completion). When a bona fide lease specifically provides that improvements to a leasehold erected by a lessee or at the lessee's expense become property of the lessor only at lease termination, the lessee is the owner of the improvements during the lease term. Hills Corp., 115 F.2d at 323. When the tenant is the owner of such improvements, the tenant is entitled to depreciation of the cost of such improvements over the lease term. Treas. Reg. §1.167(a)-4; Fort Wharf Ice Co. v. Commissioner, 23 T.C. 202, 207-208 (1954), acq. 1954-1 C.B. 4 (depreciation over ten years); Glazer Steel Corp. v. United States, 388 F.2d 990, 992, 994 (Ct. Cl. 1967).

However, the substance of a transaction, and not its form, governs its tax consequences. Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945); Frank Lyon Co. v. Commissioner, 435 U.S. 561, 572-584 (1978).

Consequently, even when a lessee-taxpayer does not possess legal title to improvements under state law, the taxpayer may acquire an ownership interest in such improvements upon the practical assumption of sufficient burdens and benefits of ownership related to the property. Major Realty Corp. v. Commissioner, 749 F.2d 1483, 1486 (11th Cir. 1985); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981); Regents Park Partners v. Commissioner, T.C. Memo 1992-336. Such assumption will be determined from the intention of the parties as evidenced by written agreements read in light of the attendant facts and circumstances at the time of the execution of the agreements. Benton v. Commissioner, 197 F.2d 745, 752 (5th Cir. 1962); Oesterreich v. Commissioner, 226 F.2d 798, 801-802 (9th Cir. 1955); Grodt & McKay Realty, Inc., 77 T.C. at 1221. The

labels applied to the transaction do not govern the nature of the taxpayer's interest in the property. M&W Gear Co., 446 F.2d at 844; Oesterreich, 226 F.2d at 801; Haggard v. Commissioner, 24 T.C. 1124, 1128, 1130-1131 (1955), aff'd, 241 F.2d 288, 289 (9th Cir. 1956).

Important factors considered in this determination include the following:

- a. Whether legal title passes to the lessee.
- b. How the parties treat the related transaction.
- c. Whether the taxpayer is acquiring any equity in the property.
- d. Whether the related documents create reciprocal present obligations in the parties (i) to execute and deliver a deed and (ii) to make payments.
- e. Whether a right of possession is vested in the taxpayer.
- f. Which party pays property taxes.
- g. Which party bears the risk of loss or damage to property.
- h. Which party receives the profits from operation and sale of property.
- i. The existence and extent of control over property in the taxpayer.
- j. Whether the transaction is at arms length.

Grodt & McKay Realty, Inc. 77 T.C. 1237-1242; Estate of Franklin v. Commissioner, 64 T.C. 752, 763-771 & n. 15 (1975), aff'd, 544 F.2d 1045 (9th Cir. 1976); Regents Park Partners, T.C. Memo 1992-336.

In leasing arrangements, the courts treat the taxpayer-lessee as the owner of real property under the following circumstances:

- a. The lessee acquires or will acquire substantial equity in the leased property through the payments under the agreements. Foyt v. United States, 561 F.2d 599, 603 (5th Cir. 1977); M&W Gear Co. v. Commissioner, 54 T.C. 385, 393-395, 398 (1970), acq., 1970-2 C.B. xx, aff'd in part on this issue and rev'd in part on other issues, 446 F.2d 841, 844 (7th Cir. 1971); Oesterreich, 226 F.2d at 802-803; Haggard, 24 T.C. at 1128, aff'd, 241 F.2d at 289.
- b. The lessee possessed an option or right to acquire property subject to a leasehold for minimal consideration. Rev. Rul. 68-590, 1968-2 C.B. 66, 67, amplified on other grounds, Rev. Rul. 73-134, 1973-1 C.B. 60 (lease agreement with a state political subdivision gave taxpayer option to purchase property financed with bonds); Oesterreich, 226 F.2d at 802-803 (\$10 to exercise option to acquire property worth \$100,000); M&W Gear Co., 54 T.C. at 394, aff'd in part on this issue, 446 F.2d at 845-846 (suggests rental payments applied to purchase price); Albuquerque v. Commissioner, 921 F.2d 1081, 1084 (10th Cir. 1990) (lessor obligated to reconvey property to lessee at end of 33-year lease for \$1,000).
- c. Negotiations evidenced lessor's and/or lessee's intent to purchase and/or sell property. Sanders v. Commissioner, 75 T.C. 157, 159, 162 (1980) (land owners insisted on selling property and refused to lease); M&W Gear Co., 54 T.C. at 386-388, 393, 396 (lease with option); Haggard, 24 T.C. at 1125 - 1126, aff'd, 241 F.2d at 289. (lease with option).
- d. Lessee's payments approximated fair market value of property. M&W Gear Co., 54 T.C. at 394; Haggard, 24 T.C. at 11245-1127.
- e. Lessee's payments were assigned to pay debt financing acquisition of property. Rev. Rul. 68-590, 1968-1 C.B. at 67 (rentals assigned and paid directly to bond trustee to pay interest and principal of bonds); First Nat. Bank in Albuquerque v. Commissioner, 921 F.2d 1081, 1084 (10th Cir. 1990) (rentals assigned to lender financing acquisition of property).

f. Initial term of lease is shorter than useful life of property. Rev. Rul. 68-590, 1968-1 C.B. at 67.

g. Rent during renewal term is nominal. Rev. Rul. 68-590, 1968-1 C.B. at 67.

h. Lease provisions related to damages and condemnation proceeds make lessee entitled to excess of insurance, condemnation, and foreclosure proceeds over rental payments and liable for deficiency. Rev. Rul. 68-590, 1968-1 C.B. at 67.

i. Lessee's payments substantially exceeded fair rental value of property. Foyt, 561 F.2d at 603; M&W Gear Co., 54 T.C. at 394-396; Haggard, 24 T. C. at 1129-1130.

However, when the evidence demonstrates that there is no intent for the taxpayer-lessee to acquire equity through the payments, the taxpayer is not treated as the owner of the property. Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319, 322 (7th Cir. 1956). Such evidence includes the following:

a. No provisions in relevant agreements required or extended option to taxpayers to purchase property subject to lease during or at end of lease term. Western Contracting Corp. v. Commissioner, 271 F.2d 694, 701 (8th Cir. 1959); Smith v. Commissioner, 51 T.C. 429, 439 (1968); Estate of Franklin, 64 T.C. at 765-766; Kansas City Southern Railway v. Commissioner, 76 T.C. 1067, 1096 (1981).

b. Lack of any evidence that title to be delivered to lessee. Estate of Franklin, 64 T. C. at 767.

c. During and at the end of the term of the lease, lessee could not dispose of retain leased property. Kansas City Southern Railway, 76 T.C. at 1096-1097, 1099.

d. All of the disputed payment was in exchange for the grant of the leasehold interest. Boos v. Commissioner, 30 B.T.A. 882, 883 (1934).

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e. Lessee's payments were not intended by either party to be applied to price of or equity in property. Bellingham Cold Storage Co. v. Commissioner, 64 T.C. 51, 60 (1975) (payments to retire bonds issued by port district in the State of Washington (port district) were for use and occupancy of property); Breece Veneer & Panel Co., 232 F.2d at 323; Boos, 30 B.T.A. at 883; Cal-Maine Foods, Inc. v. Commissioner, T. C. Memo 1977-89.

f. Lessee's payments had no relationship to value of property subject to leasehold and rental payments approximated fair or reasonable rental value of property. Breece Veneer & Panel Co., 232 F.2d at 323; Estate of Franklin, 64 T.C. at 767-768, aff'd, 544 F.2d at 1048; Benton, 197 F.2d at 753; New England Tank Industries, Inc. v. Commissioner, 50 T.C. 771, 778-779 (1968), aff'd per curiam, 413 F.2d 1038 (1st Cir. 1969) (lack of evidence that payments did not exceed fair value of right to use property and services rendered by lessor); Bellingham Cold Storage Co., 64 T.C. at 60 (in setting payments to retire bond debt, port district expected minimum or no profit from rental payments).

g. Lessor intended to retain interest in the property. Cal-Maine Foods, Inc., T. C. Memo 1977-89.

i. Lessee had no intent to purchase property. Boos, 30 B.T.A. at 883 (intent only to obtain lease).

j. Substantial sum required to obtain property over and above rent payment. Breece Veneer & Panel Co., 232 F.2d at 323; Smith, 51 T.C. at 439; New England Tank Industries, Inc., 50 T.C. at 779; Cal-Maine Foods, Inc., T. C. Memo 1977-89.

#### Issue 1 - Application of Law to Facts

[REDACTED] is a lessee of a leasehold interest in, and not the owner of the improvements, because [REDACTED] lacks sufficient burdens and benefits of ownership under either state or federal law. (b)(5)(AC), (b)(7)a, [REDACTED]

[REDACTED]  
(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,  
[REDACTED].

(b)(5)(AC), (b)(7)a,  
[REDACTED]

(b)(5)(AC), (b)(7)a,  
[REDACTED]

(b)(5)(AC), (b)(7)a,  
[REDACTED]

(b)(5)(AC), (b)(7)a,  
[REDACTED]  
[REDACTED].

(b)(5)(AC), (b)(7)a,  
[REDACTED]

(b)(5)(AC), (b)(7)a,  
[REDACTED]  
[REDACTED].

(b)(5)(AC), (b)(7)a,  
[REDACTED]



(b)(5)(AC), (b)(7)a, [REDACTED]

(b)(5)(AC), (b)(7)a, [REDACTED]

, (b)(5)(AC), (b)(7)a, [REDACTED]

(b)(5)(AC), (b)(7)a, [REDACTED]

## Issue 2 - Legal Discussion

I.R.C. §467 determines only the timing of deductions of specified types of rental expense. A lessee under an agreement subject to I.R.C. §467 must recognize rental expense ratably over the lease term and imputed interest on unpaid amounts of rent attributable to prior years. I.R.C. §467(a).

An agreement and related rents are subject to I.R.C. §467 only if the agreement is for the use of tangible property in exchange for deferred or increasing rents in excess of \$250,000.00. I.R.C. §467(d)(1) and §467(d)(2); Treas. Regs. §1.467-1(a)(2), §1.467-1(c)(1), and §1.467-1(h)(12). However, I.R.C. §467 does not determine whether a payment obligation under an agreement constitutes rent for the use of property for federal

tax purposes. Treas. Regs. §1.467-1(a)(4)(ii) and §1.467-1(a)(5).

To be deductible rent, an amount must possess the following characteristics:

- a. It is an ordinary and necessary expense incurred in the taxpayer's business;
- b. It is required for the continued use or possession of the property for the year; and
- c. It must not give the taxpayer any title or equity in the property.

I.R.C. §162(a)(3); Foyt v. United States, 561 F.2d 599, 602-603 (5th Cir. 1977); Jack's Cookie Co. v. United States, 597 F.2d 395, 399-401 (4th Cir. 1979), cert. denied, 444 U.S. 899 (1979).

To be ordinary and necessary, a rental expense must be reasonable in amount. Foyt, 561 F.2d at 603 (excessive rental payments are not ordinary and necessary); Audano v. Commissioner, 428 F.2d 251, 256 (5th Cir. 1970); Kansas City Southern Railway v. Commissioner, 76 T.C. 1067, 1104 (1981) (Service failed to show that rental payments were not reasonable).

However, rent is deductible only for the year in which it is a current cost. Bellingham Cold Storage Co. v. Commissioner, 64 T.C. 51, 57 (1975).

The substance of payments, and not their form, governs their tax consequences. B. Forman Co. v. Commissioner, 453 F.2d 1144, 1160 - 1161 (2d Cir. 1972), cert. denied, 407 U.S. 934 (1972), reh'g denied, 409 U.S. 899 (1972); United States v. Williams, 395 F.2d 508, 510 (5th Cir. 1968). Consequently, the mere fact that a party is contractually obligated to make a payment does not determine the deductibility of the payment. Jack's Cookie Co., 597 F.2d at 398-401, 405-406; B. Forman Co., 453 F.2d at 1160; Foyt, 561 F.2d at 602-03; Audano v. Commissioner, 428 F.2d 251, 256 (5th Cir. 1970). In addition, the label assigned by the taxpayer to an agreement or amount is not controlling. B. Forman Co., 453 F.2d at 1160; Jack's Cookie Co., 597 F.2d at 400; Foyt, 561 F.2d 599, 602-03 (5th Cir. 1977); Audano, 428 F.2d at 256; Southwestern Hotel Co., 115 F.2d at 688; Belz Investment Co. v. Commissioner, 72 T.C. 1209, 1225 (1979), acq. 1980-1 C.B. 1, aff'd on other grounds, 661 F.2d 76 (6th Cir. 1981); Kansas City

Southern Railway, 76 T.C. at 1093.

Whether an amount to be paid by a lessee is in substance deductible rent is determined by the parties' intention. This intention is ascertained by the terms and conditions of the agreement establishing the obligation to pay, the facts and circumstances existing at the time the agreement was made, and the form of and the practical effect on the parties. Treas. Reg. §1.61-8(c); B. Forman Co., 453 F.2d at 1160; Audano, 428 F.2d at 256; Astor Holding Corp. v. Commissioner, 135 F.2d 47, 48 (5th Cir. 1943); Benton v. Commissioner, 197 F.2d 745, 752 (5th Cir. 1952); Oesterreich v. Commissioner, 226 F.2d 798, 801-03 (9th Cir. 1955); Belz Investment Co., 72 T.C. at 1225-1229 (rent); P. Liedtka Trucking, Inc. v. Commissioner, 63 T.C. 547, 551 (1975); Kansas City Southern Railway, 76 T.C. 1093-1094.

In determining the substance of a payment, the courts have generally considered the following factors:

- a. Whether amount of annual rent to be paid was not affected or reduced by disputed amount. Thomas, 31 T.C. at 1012
- b. Whether the agreement requiring payment gave immediate leasehold interest in property to lessee. Thomas, 31 T.C. 1013.
- c. The extent to which the documents requiring the disputed amounts possess or lack independence from the documents requiring payments of rent. Williams, 395 F.2d 508; Blue Flame Gas Co. v. Commissioner, 54 T.C. 584, (1970).
- d. Whether the amounts were required to be credited against lessee's monthly rent obligations otherwise payable under lease agreements. Sleiman v. Commissioner, T.C. Memo 1997-530, aff'd on other grounds, 187 F.3d 1352 (11th Cir. 1999).

In other cases specifically involving long-term leases of real property financed with bonds, the courts have determined that a payment obligation is rent if the obligation has the following four critical factors:

- a. The payment obligation is for the use of property.
- b. The payment is geared to cover amounts necessary to service the bond debt.

c. The payment is unconditionally required to be used and used to service the bond debt during the current taxable year.

d. No portion of the amount intended to be consideration for the future use of the property.

Jack's Cookie Co., 597 F.2d at 397-402, 405-405 (amounts that lacked these characteristics was nondeductible advance rent); Bellingham Cold Storage Co., 64 T. C. at 54, 58-60.

Issue 2 - Application of Law to Facts

The weight of the evidence demonstrates that FA is not an agreement for the use of property in exchange for rent under I.R.C. §162(a)(3). An examination of the FA in the context of the ground lease, [REDACTED], and related financing documents and unrelated agreements executed by other members of the [REDACTED] related to the property in [REDACTED] County refutes any claim that the FA is an agreement for the use of property in exchange for rent.

(b)(5)(AC), (b)(7)

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a,

The above factors reflects that the FA is not a rental agreement granting [REDACTED] a right to use the property in exchange for payment of rent. Consequently, the provisions of I.R.C. §467 do not apply to the FA and related payments.

### Issue 3 - Leasehold Acquisition Expenditures

When the payments are made as consideration for execution of the related agreements resulting in a long-term leasehold interest, such payments occur in connection with the acquisition of a capital asset (a leasehold to use in its business in the future) and, hence, constitute nondeductible capital expenditures in the form of leasehold acquisition expenditures, bonuses, or advance rentals. Main & McKinney Bldg. Co. of Houston v. Commissioner, 113 F.2d 81 (5th Cir. 1940); Galatoire Bros. v. Lines, 23 F.2d 676, 676-677 (5th Cir. 1928) (obligation to pay \$16,971.62 (50% of taxpayer's profits in leased premises) and boarding costs for lessor and lessor's family (\$2,736.00 reflecting cost of meals furnished to lessor) during first year of 45-month lease); Baton Coal Co. v. Commissioner, 51 F.2d 469, 470 (3d Cir. 1931), cert. denied, 284 U.S. 674 (1931); Steinway & Sons v. Commissioner, 46 T.C. 375, 377 (1966), acq. 1967-1 C.B. 3 (payment of \$253,090.75 for rent-free occupancy for a period of two and one-half years); Saks & Co. v. Commissioner, 20 B.T.A. 1151, 1151 (1930), nonacq. X-1 C.B. 92; King Amusement Co. v. Commissioner, 15 B.T.A. 566, 569 (1929), aff'd, 44 F.2d 709, 710 (6th Cir. 1930), cert. denied, 282 U.S. 900 (1931) (payments of \$50,000 to guarantors of ten-year lease was necessary to securing lease); Appeal of J. Alland & Bro., Inc., 1 B.T.A. 631, 63 (1925), aff'd sub nom. J. Alland & Bros., Inc. v. United States, 28 F.2d 792 D. Mass. 1928) (payments totaling \$410,500 under 38-month lease).

Nondeductible leasehold acquisition expenditures may include the lessee's payment of the costs of constructing improvements on the lessor's property and assumption of the lessor's debt obligations. See United States v. Boston & Providence R.R. Corp., 37 F.2d 670, 672 (1st Cir. 1930) (payment of \$1,300,000 to satisfy lessor's debt obligation under 99-year lease that provided for annual rental of \$400,000); Southwestern Hotel Co., 115 F.2d at 687-688 (lessee's obligation to make all payments on unpaid balance of \$424,000 on note secured by mortgage on the hotel building subject to 99-year lease as further consideration for lease); Fackler v. Commissioner, 39 B.T.A. 395, 399 (1939), acq. 1939-1

C.B. 11, nonacq., 1968-2 C.B. 3 (acq. withdrawn on another issue) (obligation to pay past due taxes was consideration for 99-year leasehold); Jos. N. Neel Co. v. Commissioner, 22 T.C. 1083, 1089 (1954), acq. 1954-2 C.B. 5 (obligation to pay \$250,000 for improvements and/or cash to lessor during lease with initial term of seven years and 8 months was consideration for net lease); Berry, T.C. Memo 1978-65 (lessee's obligation to reimburse county-lessor for expenditures of \$59,000.00 for construction of leasehold improvements before possession under lease were in consideration for ten-year lease).

Factors that have been essential to a finding that payments or payment obligations constitute nondeductible leasehold acquisition costs, advance rentals, or bonuses include the following:

a. Language of relevant agreements stated that the payments were in consideration for execution of agreements related to the grant or continuation of the lease. Southwestern Hotel Co., 115 F.2d at 688 (language at beginning of lease agreement stated that payments were "as a further consideration for the lease"); Main & McKinney Bldg. Co., 113 F.2d 81 (consideration for lease over entire 98-year period); Galatoire 23 F.2d 676; J. Alland & Bro., Inc., 1 B.T.A. at 632 ("[i]n further consideration of demise"); Coronado Realty Corp. v. Commissioner, 24 B.T.A. 1022, 1025-1026 (1931) (lease stated that payment of \$150,000.00 at time of lease execution was in consideration of the rents, covenant, and agreements contained in the 99-year lease of the building); Steinway & Sons, 46 T.C. at 376-377, 379, 381-382 (consideration for grant of rent-free occupancy was also consideration for entering interdependent agreements for conveyance of property to lessee); Boos v. Commissioner, 30 B.T.A. 882, 883-884 (1934) (payment of \$25,000 to acquire 99-year lease); Saks & Co., 20 B.T.A. at 1152 (lessor, in consideration of \$200,000 paid by lessee and rents, covenants, and agreements of lessee, granted lease with original 21 term subject to four renewals of 12 years each); Petit v. Commissioner, T.C. Memo 1973-2 (bonus of \$8,000).

b. The relevant agreements did not designate explicitly or explicitly payments as consideration for the use and occupancy of the leased premises for only the year of the claimed expenditure. Galatoire, 23 F.2d at 676-7 (the terms provided that the payments were for the multiple-year period of the long-term lease).

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c. Relevant agreement specifically designated other payments and amounts as current rentals. Coronado Realty Corp. v. Commissioner, 24 B.T.A. 1022, 1024 (1931); Galatoire Bros., 23 F.2d at 676; Fackler v. Commissioner, 39 B.T.A. 395, 396, 399 (1939), acq. 1939-1 C.B. 11, nonacq., 1968-2 C.B. 3, (acq. withdrawn on another issue) (obligation to pay current taxes regarded by parties as rent, but assumption of obligation to pay past due taxes was consideration paid for grant of leasehold) .

d. Payments designated as current rent reflected fair rental value separate from disputed payment. Coronado Realty Corp. v. Commissioner, 24 B.T.A. 1022, 1025 (1931); Saks & Co., 20 B.T.A. at 1155 (agreed current rental negotiated before or without consideration of item; J. Alland & Bros., Inc., 1 B.T. A. at 631.

e. Relevant agreements provided that title and ownership of property vest in lessor. Berry, T.C. Memo 1978-65

f. Lease could not have been secured without payment. King Amusement Co., 15 B.T.A. at 567-568, aff'd, 44 F.2d at 710 (payments related to lease guarantee desired by lessor and guarantors would not guarantee without the payments); Saks & Co., 20 B.T.A. at 1155.

g. Payment was required before commencement of taxpayer's possession and use of the premises. J. Alland & Bro., Inc., 1 B.T.A. at 633 (payments of \$10,500 paid in November and December 1921 before commencement of possession on January 1, 1922).

h. Lessee acquired no rights under lease through payment. Saks & Co., 20 B.T.A. at 1155.

### Issue 3 - Application of Law to Facts

The weight of the evidence reflects that the payments under the FA constitute nondeductible capital expenditures for [REDACTED]'s acquisition of its leasehold interest in the improvements in substance and form. First, the factors that support that the FA payments did not constitute rent in the discussion of the second issue also support a finding that such payments are capital expenditures.

Second, the language in relevant agreements stated that

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the payments were in consideration for execution of agreements related to the grant or continuation of the lease. For example, the introductory language of the FA reflects that the payment obligations under the FA were expenditures necessary to finance the improvements that would be the subject of [REDACTED]'s future leasehold interest. Consequently, they were necessary to facilitate [REDACTED]'s acquisition of its leasehold interest and constitute expenditures in connection with the acquisition of a capital asset.

Third, the payments under the ground lease governed all rental payments. Fourth, [REDACTED] acquired no rights under the lease in exchange for the FA payments.

Issue 4 - Treatment of Lessee's Costs to Acquire Leasehold and Related Improvements Constructed with Proceeds of Tax-Exempt Bonds under I.R.C. §142

Capital expenditures frequently are recovered through depreciation or amortization deductions. Treas. Reg. §1.263(a)-1(b). These expenditures include the cost of acquiring a leasehold interest, the costs to a lessee of constructing buildings or permanent improvements on property having a useful life substantially beyond the tax year, or an amount paid for use and occupancy for more than a single taxable year (advance rent). Such capital expenditures are nondeductible and must be amortized over the life of the lease. I.R.C. §263(a)(1); Treas. Regs. Treas. Regs. §1.162-11(a), §1.162-11(b)(1), and §1.263(a)-2(a); M.E. Blatt Co. v. United States, 305 U.S. 267, 279 (1938); Duffy v. Central R. Co. of New Jersey, 268 U.S. 55, 63-64 (1925); Jack's Cookie Co., 597 F.2d at 405-06; Main & McKinney Bldg. Co. of Houston, Tex. v. Commissioner, 113 F.2d 81 (5th Cir. 1940), cert. denied, 311 U.S. 688 (1940); Galatoire Bros. v. Lines, 23 F.2d 676, 677 (5th Cir. 1928); Thomas v. Commissioner, 31 T.C. 1009, 1012 (1959), acq. 1959-2 C.B. 7; Southwestern Hotel Co. v. United States, 115 F.2d 686, 688 (5th Cir. 1940), cert. denied, 312 U.S. 703 (1941).

Generally, the amount of depreciation or amortization of a lessee's cost of acquiring or making improvements to the leasehold interest is determined under I.R.C. §178 and related regulations.

Absent other restrictions, property that is financed directly or indirectly by proceeds of tax-exempt bonds issued

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[REDACTED]

after March 1, 1986, is depreciated under the alternative modified costs recovery system (MACRS). I.R.C. §168(f)(12) (in effect for 1992); I.R.C. §168(g)(1)(C) and §168(g)(5)(A) (successor to §168(f)(12)).

However, in the case of improvements specifically paid for with tax-exempt bonds under I.R.C. §142, the lessee is prohibited from deductions for depreciation related to such property by its irrevocable election not to claim depreciation. I.R.C. §142(b)(1).

#### Issue 4 - Application of Law to Facts

The [REDACTED] is attempting to circumvent the prohibition on deductions for depreciation under I.R.C. §142 related to the [REDACTED]. The FA payments constitute nondeductible capital expenditures of [REDACTED] in the nature of acquisition costs for the leasehold interest in the [REDACTED] bonuses, or advance rentals related to such facility that are subject to amortization over the lease term. Based on the funding of such facility with the tax-exempt bonds and the election by [REDACTED] in the FA not to claim depreciation related to the facility, the [REDACTED] is not entitled to any deductions for amortization of such payments.

#### Conclusion and Recommendations

[REDACTED] is not the owner of the leasehold improvements constructed with bond proceeds. In addition, the FA payment obligations of [REDACTED] do not constitute deductible rent expense under I.R.C. §162(a)(3) and §467. The related agreements and circumstances reflect that these amounts were not for the use of the property, but are nondeductible capital expenditures under I.R.C. §263 that cannot be amortized or deducted by virtue of an election under I.R.C. §142(b)(1).

(b)(5)(AC), (b)(7)a,  
[REDACTED]

(b)(5)(AC), (b)(7)a,  
[REDACTED]

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a

8. Secure the following additional documents:

(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a,

[REDACTED]  
(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

(b)(5)(AC), (b)(7)a,

DISCLOSURE STATEMENT

This memorandum should not be cited as precedent.

In addition, this writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney

**client privilege. If disclosure becomes necessary, please contact this office for our views.**

Because no further action is required by this office, we are closing our file.

If you have any questions, please contact [REDACTED]  
at [REDACTED].

[REDACTED]  
Associate Area Counsel  
(Large and Mid-Size Business)

By: \_\_\_\_\_  
[REDACTED]  
Special Litigation Assistant  
(LMSB)

cc: TL Cats

CC:LM:RFPH:[REDACTED]:POSTF-138907-02

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cc: [REDACTED]  
(via e-mail)

cc. [REDACTED]

cc:: [REDACTED]

cc: [REDACTED]